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“Elastic Expectations” and the Austrian Theory of the Trade Cycle

By L. VON MISES

IN the thirty-one years which have passed since the first edition of my *Theory of Money and Credit* was published no tenable argument has been raised against the validity of what is commonly called the “Austrian” theory of the credit cycle. It was easy to prove that all objections brought forward were either futile or founded on a mistaken interpretation of the doctrine attacked.

However, some remarks made by Dr. L. M. Lachmann in his recent article “The Rôle of Expectations in Economics as a Social Science”¹ deserve careful consideration. In this thoughtful essay the author contends that “the Wicksellian theory appears to be based on a very special assumption, viz., of a capital market without a very strong mind of its own, always ready to follow a lead on the spur of the moment, and easily led into mistaking an ephemeral phenomenon for a symptom of a change in the economic structure. Without fairly elastic expectations there can be no crisis of the Austro-Wicksellian type” (cf. p. 23). I fully agree with this statement with exception of the use of the term “elastic”, which I would rather avoid as it implies an inadequate and misleading mechanical metaphor; furthermore, I believe that the word “boom” should be substituted for the word “crisis”.

But I want to point out that I did not fail to state the fact that my explanation of the trade cycle is based on such an assumption. In my treatise *Nationaloekonomie* (Geneva, 1940) the chapter dealing with credit expansion ends with the following observation: “This typical course of the trade cycle has sometimes been altered through the interference of extraordinary events, mostly of a political character. But by and large one can observe in Great Britain since the end of the 18th century and in Western and Central Europe and in North America since the middle of the 19th century an almost regular alternation of booms and depressions. We may wonder whether the conditions which have had this result still prevail. The teachings of the monetary theory of the trade cycle are to-day so well known even outside of the circle of economists, that the naïve optimism which inspired the entrepreneurs in the boom periods has given way to a greater scepticism. It may be that business men will in future react to credit expansion in another manner than they did in the past. It may be that they will avoid using for an expansion of their operations the easy money available, because they will keep in mind the inevitable end of the boom. Some signs forebode such a change. But it is too early to make a positive statement” (pp. 696 and 697).

It is necessary to realise that market conditions brought about by credit expansion are such that the individual businessman cannot find any fault with the situation if he is a businessman only and does not view things with the eye of an economist. There is, on the one hand, an increased demand for goods, prices are rising, and on the other hand there is an ample supply of credit at comparatively low rates of interest. There are further would-be experts who repeat again and again that good business is the outcome of some material factors, for instance technical improvements, and has nothing to do with purely monetary and credit phenomena; there is no reason, they say, to fear a change as mankind has finally entered the stage of everlasting prosperity.

Even a businessman who looks askance at the low level of interest rates brought about by credit expansion finds it hard to realise that the country or the world has really embarked upon easy money policy. For interest rates are—with the exception of the very beginning of the credit expansion—mostly not low when compared with the level which business used to consider as normal. They are low when measured by the standard which they would have to reach in a period of progressive inflation and its corollary, a general rise of prices, since they would have to include at such a time a

¹ *ECONOMICA*, X (N.S.), No. 37 (Feb. 1943), pp. 12–23.

compensation for the depreciation of the money unit going on in the period of the loan. But in order to understand this, the entrepreneur would have to be familiar with the relation between depreciation and the gross rate of interest.

The economic consequences of credit expansion are due to the fact that it distorts one of the items of the speculator's and investor's calculation, namely, interest rates. He who does not see through this, falls victim to an illusion; his plans turn out wrong because they were based on falsified data. Nothing but a perfect familiarity with economic theory and a careful scrutiny of current monetary and credit phenomena can save a man from being deceived and lured into malinvestments.

It is worth mentioning that the factors described by Dr. Lachmann provide one of the two arguments proper for a thoroughgoing refutation of the spurious acceleration theory of the trade cycle. This theory considers the entrepreneur as an automaton mechanically reacting to every increase of demand by an expansion of investment; Dr. Lachmann's reasoning must logically lead to an exposure of these fallacies. It is, of course, a minor objection only to be raised against the acceleration doctrine; the main argument is that but for credit expansion such a tendency toward additional investment would very soon be checked by the rising prices for the factors of production concerned. (Cf. my *Nationaloekonomie*, pp. 530–532.)

It is not the purpose of these cursory remarks to appraise the full content of Mr. Lachmann's contribution. I had nothing else in mind than to recall the fact that the "Austrians" are not guilty of having neglected an essential assumption of their theory.

I wish, however, to stress one more point. Why call this monetary or credit expansion theory of the trade cycle the "Austrian" or the "Austro-Wicksellian" theory? Of course, I am very grateful for the honour paid in this way to me and to my country. But why forget that this theory is a continuation, perfection and generalisation of the Currency theory? Neither Wicksell nor I myself nor Professor Hayek have ever forgotten to emphasise this point.¹

¹ On pp. 518–519 of my *Nationaloekonomie* I have tried to demonstrate in what regards the teachings of the Currency School were defective and had to be amended and supplemented by a more general theory.